

AUDITING THE MANUFACTURERS' INVESTMENT CREDIT (MIC)
(What's the Shtick About the MIC)

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AUDITING THE MIC

1. QUALIFIED TAXPAYER ISSUES

A. OVERVIEW OF SIC CODE CLASSIFICATION SYSTEM

Revenue and Taxation Code (RTC) section 23649¹(c)(1) provides:

For purposes of this section, "qualified taxpayer" means any taxpayer engaged in those lines of business described in Codes 2011 to 3999, inclusive, or [after 1/1/98] Codes 7371 to 7373, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition. (Brackets added.)

Regulation section 23649-3(a) provides:

For purposes of Regulations 23649-1 through 23649-11, inclusive, a qualified taxpayer is any taxpayer that is engaged in any activity that is described in Division D of the SIC Manual. The determination of whether a taxpayer is engaged in an activity that is described in Division D of the SIC Manual shall be made under the rules and methods described in the SIC Manual, 1987 edition, herein incorporated by reference, and the rules in this regulation on the basis of all of the facts and circumstances.

The introduction to Standard Industrial Classification of Establishments is attached as Appendix 1. In addition, the preamble to Division D, Manufacturing, is attached as Appendix 2. Many taxpayers are simply focusing on whether their business activities can be said to be generally described in a Division D, Manufacturing, SIC Code without performing the classification analysis required by the SIC Manual.

B. ESTABLISHMENT CLASSIFICATION PRINCIPLES

For purposes of SIC Manual classification, an establishment is an economic unit, generally at a single physical location, where business is conducted or where services or industrial operations are performed. (Cal. Code Regs., tit. 18, § 23649-3(b)(1).) For purposes of determining whether a business activity is a qualified activity for the MIC, you must determine the establishment(s) operated by the taxpayer. Many taxpayers are properly treated as having more than one establishment, so that each separate establishment must be analyzed independently.

¹ For purposes of this paper, the California Bank & Corporation Tax Law section reference shall be cited exclusively. The California Personal Income Tax Law contains a parallel companion section at RTC 17053.49.

Different Physical Location

Business activities conducted at different physical locations will generally be treated as separate establishments. (Cal. Code Regs., tit. 18, § 23649-3(b)(1)(A).)

Single Physical Location

The SIC Manual provides:

Where distinct and separate economic activities are performed at a single physical location (such as construction activities operated out of the same physical location as a lumber yard), each activity should be treated as a separate establishment where:

- (1) no one industry description in the classification includes such combined activities;
- (2) the employment in each such economic activity is significant, and
- (3) separate reports can be prepared on the number of employees, their wages and salaries, sales or receipts, and other types of establishment data.

These criteria have been modified in Regulation section 23649-3(b)(1)(B), which provides:

- (1) no single industry description in the SIC manual includes such combined activities;
- (2) separate reports **are prepared** on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting;
- (3) and employment in each such economic activity is significant.

For purposes of the regulation, the determination of whether the employment in each economic activity is "significant" is based upon all of the facts and circumstances; however, the activity will be deemed significant if more than 25% of the taxpayer's payroll or number of employees is attributable to the business activity being tested. (Cal. Code Regs., tit. 18, § 23649-3(b)(4).)

Accordingly, for activities conducted at separate physical locations, those activities generally stand on their own and are analyzed independently. For activities conducted at a single location (for example, R&D activity conducted on the same premises where manufacturing occurs) the activity must be analyzed in light of these three criteria.

C. OPERATING VS. AUXILIARY ESTABLISHMENTS

Auxiliary Establishments

Auxiliary establishments are primarily engaged in performing management or support services for other establishments of the same taxpayer. Auxiliary establishments shall generally be assigned the same SIC Code as the principal activity of the operating establishment they serve. (Cal. Code Regs., tit. 18, § 23649-3(b)(2).) Some examples of activities commonly performed by auxiliaries are accounting, data processing, legal services, research and development, testing and warehousing.

Manufacturing Exception

An establishment primarily engaged in providing goods or services for other establishments in SIC Manual Divisions A - D (including Manufacturing) will nevertheless be treated as an operating establishment under the provisions of the SIC Code classification rules and classified according to their principal activity. (See Cal. Code Regs., tit. 18, § 23649-3(b)(2) and Standard Industrial Classification Manual, published by the United States Office of Management and Budget, 1987 Edition, Exceptions and Borderlines, ¶ (1), p. 13.)

Research and Development

Pursuant to the SIC Manual examples, establishments primarily engaged in research, development, and testing for other establishments of the same enterprise (except for research establishments in SIC industry groups 372 or 376 – aircraft, guided missiles and spacecraft manufacturers) are classified as auxiliary establishments primarily engaged in performing support services for other establishments of the same enterprise. Research and Development auxiliary establishments are assigned the same SIC Code of the activity they support and are assigned auxiliary code number 2 under the SIC classification system. (See also Reg. 23649-3(b)(2).)

Establishments primarily engaged in research, development, and testing of products for other enterprises (as distinguished from the taxpayer) on a contract or fee basis are classified as operating establishments in Services, Industry Group 873. (Standard Industrial Classification Manual, published by the United States Office of Management and Budget, 1987 Edition, Exceptions and Borderlines, ¶ (3), p. 14.)

Operating Establishments

Any establishment that is not treated as an auxiliary establishment shall be treated as an operating establishment and assigned an SIC Code on the basis of its principal activity. (Reg. 23649-3(b)(3).) Principal activity is determined by the establishment's principal product or group of products produced or services

rendered. For establishments in Division D, Manufacturing, the data used to measure the principal activity shall be the value of production of each product produced. (Cal. Code of Regs., tit 18, § 23649-3(b)(3).) The product or service representing the largest proportion of cost of goods manufactured, excluding overhead, shall be treated as the principal activity of the establishment. In cases where multiple manufacturing and non-manufacturing activities are conducted at an establishment, if production data does not represent adequately the relative importance of each of the varied activities, then employment or payroll information may be used to determine the primary activity of the enterprise. (Cal. Code Regs., tit. 18, § 23649-3(b)(3).) Finally, it should be noted that while the principal activity inquiry may determine the taxpayer's principal SIC Code assignment as discussed above, a taxpayer may have multiple SIC Code assignments and thus the classification of each significant business activity conducted at the location must be analyzed.

2. QUALIFIED COST ISSUES

A. CAPITALIZED DIRECT COSTS OF LABOR (IRC §263A)

The capitalization rules under Internal Revenue Code § 263A were created to determine which direct and indirect costs must be capitalized to the property produced or acquired for resale, rather than currently deducted. For purposes of the MIC, however, the "direct vs. indirect cost" principles of Internal Revenue Code § 263A have been borrowed solely for the purpose of determining what are capitalized direct costs of labor (distinguished from indirect labor costs) that will qualify for the capitalized direct costs of labor exception to the general rule that sales or use tax must be paid on property in order for the costs to constitute qualified costs under the MIC. The focus of Internal Revenue Code § 263A as adopted for the MIC is not on expanding the list of capitalized costs, but instead is on properly excluding indirect labor costs from the computation of qualified costs. (See Cal. Code Regs., tit. 18, § 23649-2(b).)

Regulation section 23649-2(b) provides that the term "capitalized labor" means all direct costs of labor that can be identified or associated with and are properly allocable to the construction, modification, or installation of specific items of qualified property. The regulation goes on to provide that for purposes of determining direct and indirect labor costs that are includable in or excludable from the MIC base, the taxpayer is required to use the same (consistent) method of allocation that is required under the uniform capitalization rules specified in Treasury Regulation section 1.263A-1.

Direct labor costs under Treasury Regulation section 1.263A-1 include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. Direct labor includes all elements of compensation other than employee benefit costs, worker's compensation amounts, payments under a wage continuation plan, stock bonus, pension, profit sharing or annuity plan or other

deferred compensation plans, premiums on life and health insurance and other specified miscellaneous benefits. (Treas. Reg. § 1.263A-1(e)(2)(B).)

Indirect labor costs under Treasury Regulation section 1.263A-1(e)(3)(ii)(A) include all labor costs that cannot be directly identified or associated with the specific items of qualified property.

B. THIRD-PARTY CONTRACTORS

Legal Ruling 2000-1 (a copy of which is attached at Appendix 3) was issued to clarify the computation of direct labor costs with respect to third-party contractors. Legal Ruling 2000-1 supercedes Legal Ruling 98-1 to the extent that the two are inconsistent. Using the methodology described in Legal Ruling 2000-1, a "look-through" analysis must be performed for the third party so that only the third-party's direct labor costs will constitute qualified costs. This conclusion is consistent with the position the department has maintained since the MIC statutes were originally enacted.

C. SALES/USE TAX VERIFICATION ISSUES

Except for capitalized labor, in order to constitute qualified costs, sales or use tax must be paid, directly or indirectly, on each item of qualified property. (Rev. & Tax. Code § 23649(b)(1)(B).) The sales or use tax payment must be shown as a separately stated contract amount or determined from the books and records of the taxpayer. Where the Board of Equalization has completed an audit of the taxpayer's fixed asset purchases (such as would normally occur where the taxpayer is also a "retailer" under California sales tax law) and the MIC assets claimed were examined, either directly or through sampling techniques, in that audit, then the Board of Equalization audit results will normally be accepted for MIC purposes. If independent verification of sales or use tax payment is required (such as, for example, because the Board of Equalization audit was for different years, the taxpayer is not a "retailer" under California sales tax law, etc.), the Franchise Tax Board will conduct sampling where appropriate to verify whether payment of the sales or use tax has been made.

D. CHARGEABLE TO CAPITAL ACCOUNT

Qualified costs for the MIC must be amounts properly chargeable to the capital account of the qualified taxpayer. (Rev. & Tax. Code § 23649(b)(1)(C).) For purposes of the MIC, amounts are treated as properly chargeable to the capital account if under the qualified taxpayer's method of tax accounting they are properly includible in the qualified taxpayer's basis for computing depreciation under Revenue and Taxation Code section 24353 (federal depreciation rules). Thus, when items are "expensed" under either Internal Revenue Code § 179 or certain zone provisions with similar "election to expense" provisions, this requirement will ordinarily not be satisfied. (See Cal. Code Regs., tit. 18 § 23649-4(c).)

1031/1033 Transactions

In computing the MIC when an item of property has been exchanged for qualified property of a like kind or if replacement property similar or related in service or use has been purchased following an involuntary conversion and gain realized from the exchange or involuntary conversion is not recognized, in whole or in part, the amount that is properly chargeable to the capital account of the qualified taxpayer for California depreciation purposes for the qualified exchange or converted property must be calculated as of the date the qualified property is placed in service in California. Thereafter, the component amounts of the amount properly chargeable to the capital account must be analyzed to determine whether the individual amounts are qualified costs for purposes of the MIC. Note that in certain circumstances the amount subject to sales or use tax may differ from the amount properly chargeable to capital account in these types of transactions. Finally, once the amount of qualifying costs has been calculated, the MIC credit percentage is applied to compute the proper amount of the MIC that may be claimed.

3. QUALIFIED PROPERTY ISSUES

A. SECOND USE OF SIC CODE – QUALIFIED ACTIVITY ISSUES

In addition to being a qualified taxpayer (a taxpayer engaged in those line of business described in SIC Codes 2011 to 3999 and 7371 to 7373 of the SIC Manual), the taxpayer must also use the qualified property in an activity described in Division D of the SIC Manual (or for SIC Codes 7371 to 7373 the qualified taxpayer must use computers and computer peripheral equipment to develop or manufacture prepackaged software or custom software that is used by the purchaser to produce and sell or license copies of the program as prepackaged software). Accordingly, even though a taxpayer is properly classified as engaged in those lines of business described in an appropriate SIC Code, you must also analyze the activity to determine whether the property is actually being used in that qualified SIC Code activity.

B. COMPUTER SOFTWARE – Y2K COSTS

The department has received a significant number of inquiries regarding Y2K expenditures relating to computer software. Computer software is included under qualified property in Revenue and Taxation Code section 23649(d)(5) which states:

Subject to the provisions in subparagraph (B) of paragraph (1) of subdivision (b) [payment of sales/use tax], qualified property also includes computer software that is primarily used for those purposes set forth in paragraph (1) or (2) of this subdivision. (Brackets added.)

A separate paragraph ((d)(5)) was enacted for software because many types of software do not meet the exception for treatment as tangible personal property under Internal Revenue Code section 197(e), nor are such amounts often subject to sales or use tax where services are the true or principal object of the contract. As a result, computer software would not generally meet the MIC requirement that qualified property must be tangible personal property as described under Revenue and Taxation Code section 23649(d)(1). Therefore, computer software was specifically included as an exception to the general rule that qualified property is limited to tangible personal property, with the important additional proviso that the capitalized labor exception to the sales or use tax payment requirement generally applicable under the MIC to tangible personal property does NOT apply to computer software described in Revenue and Taxation Code section 23649(d)(5). The capitalized labor provision is contained in Revenue and Taxation Code section 23649(d)(3), which states:

The value of any capitalized labor costs that are directly allocable to the construction or modification of property **described in paragraph (1) or (2).** (Emphasis added.)

Computer software is property described in paragraph (d)(5). Therefore, capitalized labor costs allocable to that property are not qualified costs under the MIC statutes. Although some portion of Y2K costs may be attributable to computer software upon which sales tax was paid, preliminary data seems to indicate that the bulk of Y2K contracts were for non-sales-taxable labor costs associated with this software. As a result, those labor costs would not be eligible for the MIC under the foregoing analysis.

C. TANGIBLE PERSONAL PROPERTY (IRC §1245(a)(3)(A))

Revenue and Taxation Code Section 23649(d) provides, in part:

For purposes of this section, “qualified property” means property that is described as either of the following:

- (1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code for use by a qualified taxpayer in those lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification (SIC) Manual . . .

Regulation 23649-5 states:

- (a) For purposes of Regulation 23649-1 through 23649-11, inclusive, the term “qualified property” includes tangible personal property, whether new or used, that is defined in Internal Revenue Code Section 1245(a)(3)(A) and is used by a qualified taxpayer in both an activity described in Division D of the SIC Manual and primarily in a qualified activity.

Internal Revenue Code section 1245(a)(3) states in part:

For purposes of this section, the term “section 1245 property” means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either –

- (A) personal property
- (B) other property . . .

Treasury Regulation section 1.1245-3(a) states:

The term “section 1245 property” means any property . . . which is or has been property of a character subject to the allowance for depreciation provided in section 167 and which is either –

- (i) Personal property (within the meaning of paragraph (b) of this section),
- (ii) Property described in section 1245(a)(3)(B) . . .

Treasury Regulation section 1.1245-3(b) states:

The term “personal property” means –

- (1) Tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of “section 38 property” for purposes of the investment credit), and
- (2) Intangible personal property.

Some taxpayers have argued that the regulation is too narrow since the statutory reference is to Internal Revenue Code section 1245(a), which subsection includes both 1245(a)(3)(A) and (B). The department believes that the statutory phrase “tangible personal property that is defined in Section 1245(a)” contained in Revenue and Taxation Code section 23649(d) specifically references (and was intended to narrowly reference) Internal Revenue Code section 1245(a)(3)(A). The statutory reference in the Revenue and Taxation Code is limited to “personal property” and the plain language of Internal Revenue Code section 1245(a)(3)(A) is limited to “personal property.” In addition, Treasury Regulation section 1.1245-3 clearly indicates that “tangible personal property” is limited to Internal Revenue Code section 1245(a)(3)(A) property. Finally, during the regulatory process for adopting Regulation section 23649 a certification was required that the regulation did not impact the revenue projection provided at the time the statute was adopted. A narrowing of the scope of the statute would have resulted in a revenue gain since fewer taxpayers would have been eligible for the credit. The certification of no revenue impact reflects the fact that the regulation is not narrower than the scope of the underlying statute. In order to prevail on the argument that the regulations are

too narrow, a taxpayer would be required to show that this portion of the regulations adopted pursuant to Revenue and Taxation Code section 23649 are invalid.

With respect to defining tangible personal property, Treasury Regulation section 1.48-1(c) provides:

For purposes of this section, the term “tangible personal property” means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures).

The issue of what constitutes an “inherently permanent structure” has been the most difficult audit issue in this area. The term is not defined in the statute or regulations and it is a difficult concept to define. Cases under the old federal Investment Tax Credit had a very difficult time reaching consensus on specific items and categories of property that fell within these classifications. In the seminal case of *Whiteco Industries, Inc v. Comr.* (1975) 65 T.C. 664, the United States Tax Court reviewed the applicable case law and concluded six questions must be addressed to determine whether a particular asset is properly treated as tangible personal property:

1. Can the property be moved or has it been moved?
2. Is the property designed to remain permanently in place?
3. Are there circumstances which show that the property may or will have to be moved?
4. Is the property readily moveable?
5. How much damage will the property sustain when it is moved?
6. How is the property affixed to land?

Since the MIC statutes reference Internal Revenue Code section 1245(a) and tangible personal property, the department is utilizing the Whiteco factors in examining whether any particular asset is an inherently permanent structure rather than tangible personal property. Taxpayers should be familiar with this decision and related cases in analyzing whether specific items of property constitute tangible personal property for purposes of the MIC.

D. LEASING

Under California sales and use tax law, sales or use tax payments in a leasing transaction may either be made upon the acquisition of the item of property to be leased (sales or use tax payment based on the acquisition price of the asset) or periodically during the term of the lease (use tax payment based on the amount of the lease payment. For purposes of the MIC, generally the lessor must pay the sales tax upon the acquisition of the leased property based upon the acquisition price of the asset to the lessor. In the absence of this crucial MIC requirement, standard business leasing practice in the non-finance lease setting would result in

the lessor acquiring the property that is the subject of the lease "ex-tax" by the delivery of a resale certificate to the seller so that sales tax is **not** collected "up front." Instead, a use tax would thereafter be collected based on the amount of each lease payment and remitted by the lessor to the Board of Equalization. Accordingly, in order for non-finance leases to qualify for the MIC, parties to a leasing transaction must deviate from the normal business practice of collecting and remitting use tax on the lease payment stream.

Another important rule for purposes of the MIC is that the sales and use tax treatment of a lease are used to analyze the transaction, rather than the income tax treatment of that lease. Under a lease construed as an **operating** lease for sales tax purposes (true lease where property returns to lessor at end of the lease term and the transaction is treated as a continuing sale under California sales tax law), the California sales or use tax paid by the lessor must be based on the lessor's acquisition price in order for the **lessee** (NEVER the lessor) to claim the MIC. Assuming the other requirements for claiming the MIC are met, the fact that a portion of the monthly lease payments are computed so that the lessee effectively reimburses the lessor for the sales or use tax paid "up front" on the lessor's acquisition of the leased property will not prevent the lessee from claiming the MIC. The critical question is whether the sales or use tax was paid by the lessor based upon the acquisition price of the asset and remitted to the Board of Equalization when due at the time of acquisition of the to-be leased asset. For example, if a lessor pays \$100 for an item of qualified property, plus \$7 in California sales tax on that item, then the lessee (qualified taxpayer) may claim the MIC on the cost of \$100 even if the lessee subsequently reimburses the \$7 of sales tax to the lessor.

Under a lease construed as a **finance** lease for sales tax purposes (de facto sale where title transfers to lessee at end of lease term and treated as an immediate sale under California sales tax law), either the lessor or the lessee must pay California sales or use tax upon inception of the leasing transaction. However, for a finance lease, the California sales or use tax paid by either the lessor or lessee must be based on the lessee's acquisition price. For example, on May 15, 1994, G, which is engaged in the equipment leasing business, purchases two grinders for \$200. On May 15, 2000, G leases the two grinders to F, a qualified taxpayer for \$33 per year for a term of 3 years. Upon the expiration of the 3-year term, F has an option to acquire the property for \$1. The total cost under the terms of the finance lease for the property is \$100. If either G (the lessor) or F (the lessee) remits the \$7 in California sales tax to the Board of Equalization at the inception of the leasing transaction (which should be required because it appears under California sales or use tax law that the tax would be due at inception), then F would be entitled to claim the MIC on the purchase price of \$100.

E. DUAL USE PROPERTY

Certain assets are utilized for more than one purpose (manufacturing element and some non-manufacturing element in the same asset). The department has

encountered this circumstance in the area of cement trucks (both a manufacturing and transportation element in the same asset). The department had stated previously that cement trucks would not qualify as tangible personal property due to the transportation element representing the primary use of such asset (non-manufacturing activity). This position has been revised based in large part upon the inclusion of a delivery element within the particular SIC Code description as part of the manufacturing activity, and thus the elements of the asset are now being bifurcated by the department so that the portion of the asset primarily used in manufacturing (the concrete mixing drum and related truck mounted equipment) **may** be eligible for the MIC. The cost of the truck or trailer chassis, however, which the department still believes is primarily used in transportation does not qualify for the MIC. The transportation element determination for cement truck or trailer chassis is consistent with former federal excise tax rules.